

Modification proposal:	Uniform Network Code (UNC) 310: 'Removal of DNO Users from UNC TPD V3.3.4' & 'Removal of DNOs as Users from UNC TPD V3 and V4' (UNC310 & UNC311)		
Decision:	The Authority ¹ directs that proposal UNC310 be made ²		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	16 December 2010	Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposal

In 2005 Ofgem published its best practice guidelines for gas and electricity network operator credit cover ('the guidelines')³. The aim of the guidelines was to ensure that network operators' credit cover and payment terms were proportionate, allowing network operators to properly manage, rather than wholly avoid, any exposure to financial risk. The guidelines also set out our views and criteria for the pass through of any bad debt. This could be summarised as requiring a demonstration of adherence to best practice, as may be set out in the guidelines or elsewhere. In recognition that best practice is constantly evolving, we suggested that the guidelines should remain under periodic review.

On 19 January 2009 Ofgem approved UNC195AV which introduced reform of the booking arrangements for exit capacity from the National Transmission System (NTS)⁴. These new exit arrangements are for the use of capacity from 1 October 2012, and the new booking arrangements were implemented on 1 April 2009. As part of the new exit arrangements National Grid Gas (NGG) will facilitate the assignment of registered exit (flat) capacity between users.

Review Proposal 252 was raised in April 2009. Its aim was to review the UNC credit arrangements for transportation charges and consider whether they remained fit for purpose in light of the many credit issues which have arisen since publication of the guidelines. Examples of such issues are the collapse of financial institutions such as *Lehman Brothers* and the wider 'credit crunch'. The Review Group came forward with 14 recommendations, each of which has now been raised as an individual modification proposal.

The modification proposal

UNC310 seeks to modify the definition of Users for the purposes of Section V 3.3.4 only. The effect of this change would be to exclude DNO Users from the requirement imposed by modification UNC195AV that all Users to put in place credit cover for 12 months of Exit (Flat) Capacity charges. The proposer contends that this was not the intent of UNC195AV, but is an unintended consequence resulting from the implementation of the

¹ The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

² This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

³ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=9791-5805.pdf&refer=Licensing/IndCodes/CreditCover>

⁴ See the decision on UNC195AV published on 19 January 2009 on the Joint Office website www.gasgovernance.co.uk.

earlier modification UNC127⁵, which referenced Distribution Network Operators (DNOs) for credit and invoicing purposes.

UNC311 goes further than UNC310, as it would amend the definition of User for the whole of UNC Section V paragraphs 3 and 4. UNC311 would therefore also address the credit cover issue mentioned above, but in summary would also:

- remove the requirement for DNOs to provide security for any NTS charge; and,
- remove the suggestion that the DNOs could be terminated from the UNC.

The proposer of UNC311 considers that this proposal will not only achieve the benefits of UNC310, in avoiding what it considers to be the inefficient costs of securitising Exit (Flat) Capacity charges, but give recognition to the fact that the DNOs are different to UNC Shippers and should therefore not be bound by the same credit requirements. However, the proposer also considers that the current arrangements are discriminatory in that they do not place the same requirements upon National Grid Distribution as the independent DNOs, for instance the requirement to lodge security with National Grid (NTS). The proposer considers that the implementation of UNC311 would remove those discriminatory provisions and place all DNOs on an equal footing.

The proposers each consider that their proposal would better facilitate relevant objectives a), d) and f) of the UNC.

UNC Panel⁶ recommendation

At its meeting of 19 August 2010 the UNC Modification Panel voted unanimously to recommend the implementation of UNC310. At that same meeting the UNC Modification Panel also voted by a majority to recommend implementation of UNC311.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Reports (FMRs) dated 28 August 2010 and 10 November 2010. The Authority has considered and taken into account the responses to the Joint Office's consultations on the modification proposals which are attached to the FMRs⁷. The Authority has concluded that:

1. implementation of modification proposal UNC310 will better facilitate the achievement of the relevant objectives of the UNC; and
2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties⁸.

⁵ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=181&refer=Licensing/GasCodes/UNC/Mods>

⁵ UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com

⁶ The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

Reasons for the Authority's decision

We agree with the proposers' and the UNC modification panel's view that these proposals should be assessed against each of relevant objectives a), d) and f), being reasonably expected to be neutral in respect of the other objectives.

We note that there were twelve responses to the parallel consultations on UNC310 and 311 (including separate responses from National Grid Distribution and National Grid NTS). Of those, eight were in support of the implementation of UNC310. A further two offered comments only, while National Grid NTS offered qualified support. Only one respondent was opposed.

Six respondents were in favour of implementing UNC311, with a further two offering comments only. Four were opposed.

Relevant Objective (a): the efficient and economic operation of the pipe-line system to which this licence relates;

It was suggested by the proposers that both UNC310 and UNC311 would further relevant objective (a) by allowing the DNOs to avoid what they consider to be an inefficient and unwarranted increase in the costs for operating their networks. While these costs were not quantified, the proposer of UNC311 suggested that when UNC195AV comes into effect it would be required to securitise approximately £45m of NTS Exit capacity Charges (£30m additional and circa £15m unsecured).

As shown in our recent Impact Assessment and subsequent decision on UNC modification proposal 246 and its alternatives⁹, we consider that the benefits of additional security can be more than off-set by the costs of that security, particularly where there is a relatively low risk of default. However, we acknowledge that it was not the intent of UNC195AV to impose a requirement upon DNO users to securitise their Exit Capacity bookings and agree with the comments made during the UNC252 review and the development of UNC261¹⁰, that the independent DNOs do impose a different and lower credit risk to National Grid NTS than UNC Shippers.

Given the unintended impacts of UNC195AV, there is no evidence to suggest that the additional costs which will otherwise be born by the independent DNOs are warranted. We therefore agree that the removal of this unintended exposure to costs will therefore better facilitate the efficient and economic operation of the system.

Relevant Objective (d): so far as is consistent with subparagraphs (a) to (c) the securing of effective competition: (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers;

We note that the one respondent who opposed the implementation of either UNC310 or UNC311 considered that either would have a discriminatory effect, creating different credit requirements for DNOs and for UNC shippers. Whilst we agree that it is inappropriate to *unduly* discriminate between different categories of UNC party, we consider that the application of differing credit arrangements can be objectively justified.

⁹ UNC0246/246A/246B: Quarterly NTS Entry Capacity User Commitment

¹⁰ UNC261: 'Annual NTS Exit (Flat) Capacity Credit Arrangements'

It is legitimate to differentiate between parties where there is a relevant difference, while parties that are alike in all relevant aspects must normally be treated on an equal basis.

We agree with those respondents who noted that with respect to credit cover requirements and the extent to which NTS Exit (flat) capacity bookings impose a risk upon NG NTS, there is a legitimate difference between shippers and DNOs. Further, as UNC Shippers and DNOs are not competing with each other for NTS Exit (Flat) Capacity, we do not consider that this differentiation would have any impact upon competition.

Similarly, while we appreciate that the existing credit requirements may apply to the independent DNOs but not the retained DNOs, we do not consider that it is practicable or appropriate for credit cover to be lodged with one part of an organisation by another. We also note that neither UNC310 nor UNC311 seek to amend Section V 3.1.2 which states that:

“National Grid NTS and National Grid Gas plc as a DN Operator shall be construed as a reference to a single Transporter”

We therefore consider that neither UNC310 nor UNC311 would have any practical benefit in this regard, though nor would they be detrimental. We therefore consider that both UNC310 and UNC311 would be neutral against this relevant objective.

Relevant Objective (f): the promotion of efficiency in the implementation and administration of the network code and/or the uniform network code;

The proposer of UNC310 considers that its implementation would simplify the credit arrangements for all DNOs as it would allow common, pre-UNC195AV provisions to continue. They state that the additional degree of securitisation that may otherwise be required from iDNOs and not National Grid’s retained DNOs (rDNOs) would create a two-tier system. However, one respondent, while supporting the proposal, disagreed with this assessment. They noted that the UNC does not differentiate between the credit requirements of iDNOs and those owned by National Grid.

We agree that the UNC credit arrangements do not currently differentiate between iDNOs and rDNOs. However, we consider the implication of the proposer’s comment to be that if the UNC195AV requirement to securitise 12 months of Flat capacity were to remain, the iDNOs would seek to introduce further changes in order that these costs can effectively be passed through to Users. DNOs would of course be at liberty to raise such proposals, but as this is an as yet hypothetical impact we cannot appropriately consider that as part of this decision.

The proposer of UNC311 suggests that its implementation would remove an unworkable DNO termination facility in Section V paragraph 4 of the UNC. We consider that the position with respect to the potential termination of an iDNO from the UNC is ambiguous, if Section V of the UNC is considered alone. We agree with National Grid NTS that the UNC text does not rule out the possibility of an iDNO being terminated for the same reasons as any other UNC User, for instance defaulting on UNC credit obligations. However, as National Grid NTS points out, there are a number of further arrangements which must also be considered, not least the powers provided to the Authority under the Energy Act 2004 for dealing with a network company in deteriorating financial health¹¹.

¹¹ See: [www.ofgem.gov.uk/Networks/Policy/Documents1/GUIDANCE%20DOC%20\(DECISION%20DOC\)%20-%20FINAL.pdf](http://www.ofgem.gov.uk/Networks/Policy/Documents1/GUIDANCE%20DOC%20(DECISION%20DOC)%20-%20FINAL.pdf)

More generally, we agree that the many of the provisions within paragraphs 3 and 4 of Section V were originally intended to apply to the credit arrangements of gas shippers rather than GDNs, and we do not consider that it would be appropriate to remove them entirely. To the extent that the GDNs do not consider that they reflect their particular circumstances and the level of risk they impose upon NG NTS (and other GDNs) it may be appropriate to develop alternative, targeted arrangements. In the absence of any replacement arrangements, we consider that the provisions currently provided by Section V are fit for purpose and preferable to a vacuum. Therefore, while we will be happy to reconsider this issue in future, perhaps as part of a wider review of the credit cover best practice, we do not consider that the current drafting is detrimental to the efficient administration of the UNC and that a blanket removal such as that proposed by UNC311 should be implemented at this time.

Taking into account each of the points raised above, we consider that either UNC310 or UNC311 would better facilitate the relevant objectives of the UNC than the current baseline, as each would avoid the GDNs incurring potentially inefficient costs. To the extent that UNC310 provides a more targeted solution and does not additionally seek to exempt GDNs from all other provisions within Section V paragraphs 3 and 4, we consider that it is preferable to the alternative UNC311 at this time.

Decision notice

In accordance with Standard Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC310: *'Removal of DNO Users from UNC TPD V3.3.4'* be made.

Rachel Fletcher

Partner, Distribution

Signed on behalf of the Authority and authorised for that purpose

Appendix A: Key features of NTS Exit Flat Capacity

The main characteristics of the proposed “flat capacity” product are:

- **Long term allocation of existing “flat capacity”:** existing “flat capacity” will be made available at regulated prices. Existing users are assumed to have “prevailing rights” for such capacity and would be required to give 14 months notice should they wish to reduce their requirement;
- **Long term allocation of incremental “flat capacity”:** incremental “flat capacity” (i.e. in excess of a user’s prevailing rights) would be made available at regulated prices to all classes of network users, who would be required to commit financially to purchasing capacity rights for a four year period in order to trigger the release of incremental capacity (Users would be unable to reduce their aggregate requirements until the User Commitment period has been met);
- **Medium / short-term capacity allocation:** unsold capacity would be made available to network users in pay-as-bid auctions in the medium and short-term. Capacity would be offered for sale on a nodal (supply point) basis;
- **Interruption arrangements:** interruption of “flat capacity” would be managed by NGG NTS through the scaleback of the day-ahead interruptible product (made up of ‘use it or lose it’ (UIOLI) and NGG NTS discretion) and through the long-term buyback contracts with network users that NGG chose to contract with;
- **Over-run charges:** Overrun charges would apply if the aggregate end-of-day flow of all users at an exit point exceeded the aggregate end of day “flat capacity” held by all users at the exit point;
- **Trading:** shippers and DNOs would be able to trade capacity at a node but not between nodes, although GDNs would be able to request from the NTS (and vice-versa) the ability to substitute capacity between nodes for operational reasons where this is possible.